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Egypt Economic/Political Outlook 2011-2012
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POLITICAL STABILITY: **Egypt** has entered a period of heightened political instability, which will continue for the first half of the **forecast** period. The popular uprising, which led to the ouster of Hosni Mubarak, the former president, was a momentous event unparalleled in the modern history of **Egypt**. Mr Mubarak's resignation on February 11th was expedited after the Supreme Council of the Armed Forces put pressure on him to stand down. The army council, headed by Field Marshal Mohammed Tantawi, has dissolved parliament and will govern by constitutional decree until it hands power over to an elected civilian government. New parliamentary and presidential elections were scheduled to take place in September and possibly December, respectively, but the army has now delayed the legislative election until November.

ELECTION WATCH: The Supreme Council of the Armed Forces dissolved the National Democratic Party-dominated parliament following Mr Mubarak's resignation in February. In mid-March a majority voted in favour of a package of amendments to the constitution in a referendum, paving the way for a legislative election to be held in September and a presidential election to follow. However, following a new outbreak of mass protests, the army council decided to postpone the parliamentary election, although it is still scheduled to go ahead before the end of the year.

INTERNATIONAL RELATIONS: In the wake of the revolution, **Egypt** received pledges of political and economic support from key international players seeking to facilitate its transition to a more democratic system. The US, the World Bank and the IMF committed to providing **Egypt** with billions of US dollars of financial assistance. Egypt's subsequent decision to turn down help from the IMF and the World Bank will not have an adverse effect on its relations with the multilateral organisations and they are likely to come to its aid again in the future if required. Separately, Gulf countries, including Saudi Arabia, Qatar and the UAE have announced multi-billion-dollar investments in **Egypt**, and Saudi Arabia has also offered direct budget support.

POLICY TRENDS: Political instability will delay the implementation of planned economic reforms and liberalisation. Before his resignation, Mr Mubarak dismissed the liberal cabinet that oversaw a period of strong, investment-led, economic growth between 2005 and 2008, and was planning to enact further reforms aimed at developing the capacities of the private sector and pushing growth up towards 9%. The interim government has recognised the need for further reform but says that it does not have the mandate to implement it. The budget for fiscal year 2011/12 (July-June) demonstrates an aspiration to achieve greater social equality. The budget includes significantly larger allocations to subsidies and higher government investment compared with the current budget. The additional costs will be financed through higher taxes, grants and domestic borrowing. The previous government had set ambitious targets for investment in infrastructure through awarding public-private partnership contracts. In its economic programme for 2011/12, the interim administration has announced its intention to restart this initiative. If the transition period culminates in the election of a civilian president, there is a chance of some of the liberal economic policies of the recent past being revived. However, this will be complicated by ongoing legal challenges to a series of deals completed under the Mubarak regime, including much of the privatisation portfolio.

ECONOMIC GROWTH: The Economist Intelligence Unit expects real GDP growth to have slowed to 1.2% in 2010/11 owing to the ongoing disruption caused by the political crisis. Official estimates put growth in the first nine months of the fiscal year (July-March) at 2.3%, with the economy contracting by 4.2% in the third quarter. Political upheaval will have continued to affect growth in the fourth quarter, and private consumption and exports, particularly of services, are likely to have been significantly affected. The 2011/12 budget assumes that growth will accelerate to 3.2% in the new fiscal year. However, we **forecast**a more robust recovery predicated on a helpful base effect in the second half of the fiscal year. We have lowered our growth **forecast** for 2011/12 to 3.9% (previously 4.6%) to reflect the government's decision to revise down its expenditure target for the new fiscal year. In addition, the government's rejection of US$3bn in assistance from the IMF is likely to curtail spending.

INFLATION: Having peaked at an average of 18.3% in 2008, the year-on-year rate of inflation fell steadily thereafter, averaging 11.1% in 2010. However, rising food and fuel prices created inflationary pressures towards the end of 2010, and these factors will be exacerbated by the depreciation of the Egyptian pound as a result of the political crisis.

We expect inflation to peak at 16.2% in 2011 before slowing gradually, averaging 10.4% over the **forecast**period, as the exchange rate stabilises and global commodities prices ease.

EXCHANGE RATES: The exchange rate is driven in large part by capital flows and developments with the US dollar. Egypt's robust economy and high interest rates compared with much of the rest of the world had attracted substantial carry-trade inflows in recent years. The trend has now reversed and the Egyptian pound slipped to a five-year low against the dollar in late October 2010, possibly with some help from the Central Bank of **Egypt**. Since the January revolution, the pound has continued to depreciate. In light of ongoing political uncertainty, we expect the pound to weaken further, averaging EP6.10:US$1 in 2011. The currency is expected to strengthen as the political situation stabilises, but will remain weaker than in recent years, as the euro is **forecast** to fall gradually against the dollar. It will average EP6.07:US$1 in 2011-15, compared with an EP5.63:US$1 in 2010. The pound will depreciate less against the euro, averaging EP7.69:€1 in 2011-15 (compared with the 2010 average of EP7.46:€1, but down from a peak of around EP8:€1 in late October 2010).

EXTERNAL SECTOR: The trade deficit will widen in 2011 before recovering slightly in 2012-13, driven partly by strengthening external demand, before widening again over the remainder of the **forecast** period. Import growth will slow in 2012 on the back of lower commodities prices, before picking up gradually up to 2015. The non-merchandise surplus will narrow significantly in 2011 as service exports, namely tourism, will be affected by the political crisis. It will recover gradually over the remainder of the **forecast** period, as domestic stability is restored. The transfers account will maintain a solid surplus, and the income balance will remain negative throughout the**forecast** period. The current account will remain in deficit until 2014, when it will move into surplus as the services and transfers surpluses strengthen.